Bond Market Liquidity and Its Impact on Your Portfolio

There are many headlines warning investors about the next possible financial emergency—the lack of liquidity in the bond market.

The meaning of liquidity and the essence of the problem are not obvious. The media tends to look at the bond market as a monolithic block with bond yields either rising or falling. However, there are many different bond markets and many different types of investors in the bond market. Some bonds and some bond markets are more liquid than others.

This article examines the general concept of liquidity, how it applies to the bond market, the factors that affect bond market liquidity and how the concept of liquidity applies to your investment in money market funds, mutual funds and exchange-traded funds (ETFs).

What Is Liquidity?

Liquidity may be defined as the ability to turn an investment asset into cash within a reasonable period of time and at a reasonable price. If an asset can be sold quickly, but at a significant loss, it is not liquid. Liquidity generally is more easily found in a market with a high trading volume and many investors. High trading volume may mean that there are many buyers seeking what you have to sell at a reasonable price. However, if there are only a few buyers, and these buyers have already purchased what they wanted, liquidity may dry up.

Matt Levine observed on Bloomberg View that what investors are often looking for is immediacy, not long-term liquidity. Immediacy means that when you decide to sell, there will be someone willing to buy. The willing might include individual investors, fund companies, speculators or dealers. Individual investors generally buy and hold. Fund companies may trade or hold bonds.

Speculators and dealers buy and sell for their own accounts. They are in the business to make a profit. They will buy what you have to sell if they believe that they can turn around and sell it to someone else at a profit. They are not in the business of buying if they also cannot sell. Doing so ties up their capital.

Liquidity for a particular asset may not be a permanent state. It may be transitory. If you have a small quantity of an item to sell, you may be able to sell it easily without affecting the price. If you have a large quantity to sell, you may find that the liquidity dries up as the market becomes saturated. If buyers sense a large supply, they may decide to reduce their price. The more an investor needs to sell, the less the buyers may be willing to pay. It would be appropriate to say that liquidity is subject to market conditions.

There tends to be more liquidity in the U.S. stock market, particularly for large-cap stocks, than in certain bond markets. Even a small, thinly traded stock may, under normal conditions, be traded on the same day and at a reasonable price. This liquidity may not apply to certain foreign stocks, as has occurred in China over the past few months. It also does not apply during market meltdowns, as occurred in 2008 when liquidity for generally all investments—with the exception of Treasuries and other high-quality bonds—dried up.

Treasury Bond Liquidity

Treasury bonds issued by the U.S. government enjoy a deep pool of liquidity. The October 15, 2014, “flash crash,” when the yields on Treasury bonds plummeted and then recovered quickly, tested the notion that it is possible to trade large blocks easily at all times with basic price stability. Markets change. The following was reported in The Wall Street Journal:

“As of [June 2015], it would have taken the equivalent of 25 days for all available Treasuries to trade, up from eight days a decade ago, when the market was one-third of its current size, according to data from the Securities Industry and Financial Markets Association.”

This statement refers to “all available Treasuries,” assuming that all Treasury bonds are equally liquid and affected by the same factors. The most liquid assets are Treasury bills and short-term notes and funds that hold those assets such as mutual funds and ETFs. However, longer-dated Treasury bonds are affected by the same macro scenarios that affect all long-dated bonds: namely, the threat of inflation and the likelihood of declining interest rates. The Wall Street Journal quote states that it took longer to sell, but does not tell us if all sectors were equally affected. The strength of Treasury bonds lies in the government’s willingness to support and protect them.

Matrix Pricing

Bond pricing is set at the margin. What this means is that most bonds do not trade daily, but those that do set the price and liquidity for the rest of the market. While you may sell a small position and not move the market, the largest positions will set the price for all bonds in their categories.

The large positions are used as the basis of matrix pricing. Third-party companies use formulas and algorithms based on assumptions of how the financial markets work to create the matrix. This sets prices on infrequently traded or small-lot-size bonds. Bill Gross, a co-founder of PIMCO and now the manager of the Janus Global Unconstrained Bond Fund (JUCTX), pointed out in Bloomberg Businessweek that, since it is not necessarily based on actual trades, these assumptions can change. Also, the matrix may not represent actual on-the-ground pricing for retail-sized trades.

How Liquid Are Funds?

The ability to quickly and easily redeem shares of a fund depends on both the type of fund and the types of securities the fund invests in.

Money Market Funds

The most liquid assets, aside from Treasury bills, are money market mutual funds. Money market funds all used to be redeemable at par (face value), or $1 per share. In 2008, the Reserve Primary Fund broke the buck: It was unable to redeem shares at full face value because it contained 1.5% commercial paper—short-term loans of nine months or less (270 days)—issued by Lehman Brothers, which had just declared bankruptcy. Investors were concerned about what else might be owned by the fund and what other calamity might happen. Two-thirds of the assets exited the fund in 24 hours. After fund assets were frozen for seven days, the run on the fund began again and the fund was forced to liquidate. This freeze could have triggered a run on all money market funds.

To deal with this emergency, the federal government instituted a Temporary Guarantee Program to stabilize the money market fund industry at $1 per share. Eventually, the government was able to remove the guarantee and instituted money market reforms. As a result of SEC Rule 2a-7, money market funds must maintain a specified amount of daily and weekly liquid assets. Beginning in October 2016, only money market funds holding U.S. government securities will provide a fund guarantee of redemptions at par ($1 per share).

Those seeking higher yields from money market funds holding corporate bonds or tax-exempt yield from funds holding municipal securities will face the possibility of so-called “gates” and fees. A gate is a halt on all shareholder redemptions, which may be imposed for a period no longer than 10 consecutive days, or 10 days in a 90-day period. A fee may be imposed on those exiting the fund to transfer the cost of selling securities in an illiquid market.

As of April 2016, daily disclosures of daily and weekly liquid assets, as well as net shareholder flows from the previous day, must be posted on a money market fund’s website. Fund managers are required to know their customers, so they will be able to anticipate large cash flows.

Bond Mutual Funds and ETFs

Mutual funds and ETFs that hold bonds have their own liquidity needs if they are going to be able to meet your requests to sell your shares. How do they meet your needs?

All funds maintain a cash position in order to redeem your shares and buffer the funds from market forces. Corporate bond funds have established lines of credit with banks and have increased the amount of cash they are holding in case there is panic selling. BlackRock is seeking government clearance to set up an internal program whereby funds hit with redemptions beyond their capacity could borrow from sister funds that are flush with cash, according to Investment News and Bloomberg.

Mutual funds are not any more liquid than the assets they hold. Currently, you can redeem a mutual fund any weekday and receive the closing price in cash for the net asset value (NAV) at the close of that day. However, if the market for the underlying assets held by the fund is weak because credit is drying up, they may not be able to sell some assets. They will choose the most liquid assets to sell.

Many investors select a mutual fund by looking for the ones that yield the most. That seems sensible on the face of it. Why would an investor want to select a low-yielding bond fund? However, if a mutual fund is outperforming all of the other mutual funds in its class, it is doing so because of one or more of the following reasons:

- It is investing in riskier, less-liquid assets;
- The bonds held by the fund have lower ratings;
- The maturities are longer; or
- It is using structured products.

For example, the Oppenheimer Rochester Maryland Fund (ORMDX) yielded much more than other Maryland mutual funds because 46% of its assets were invested in triple-tax-free bonds of Puerto Rico, which declared a default on certain of its bonds in 2015. A fund is only as liquid as its underlying assets. It is important to look under the hood to see what engine is installed to generate returns.

It has been reported that some funds, like the PIMCO Total Return Fund (PTTRX), reserved the option to return assets instead of cash if an investor held a position of $250,000 or more. If this option were to be executed, a PIMCO fund shareholder might find him- or herself with a grab bag of what The Wall Street Journal’s Jason Zweig described as the funds’ “more than 6,000 holdings that could include Spanish and Greek government bonds, mortgage-backed securities, bank loans, municipal bonds, foreign-currency contracts, interest-rate swaps, credit-default swaps and other complex ‘derivatives.’” Do you read the fine print in a fund’s prospectus?

ETFs are supposed to be very liquid because share owners can sell their shares at any time of the day, as long as there is a buyer for them. The share owners are unconstrained sellers because the price they sell at is not required to be the net asset value. The underlying assets are traded and arbitraged by the authorized participants (large institutions), who it is hoped keep the price of the assets close to the net asset value. ETF shares can be priced higher or lower than the net asset value. They may even trade independent of the underlying assets, as in the case of the Greek stock market. In this particular case, when trading stopped in the Greek stock market, it continued in the Global X FTSE Greece 20 ETF (GREK)—even after the Greek stock market completely closed.

However, despite the possibility of trading ETF shares when an exchange is closed, the actual managers of the ETFs are not so sanguine. According to ZeroHedge, ETF managers are setting up lines of credit with banks to delay the need to sell assets into a shriveled market. Bill Gross sent a note to shareholders about how a downturn might affect “mutual funds, ETFs and even index funds.” He stated that “the obvious risk—perhaps better labeled the ‘liquidity illusion’—is that all investors cannot fit through a narrow exit at the same time.” The Wall Street Journal reported that activist investor Carl Icahn, at a hedge fund conference in New York, stated “that some ETFs have bought so many riskier and infrequently traded bonds that it isn’t clear who will buy them or at what price, should the funds be forced to sell during a market panic.”

It is not clear how the authorized participants (the institutions) will behave in a constricting market, how that will affect the net asset value of ETFs and ultimately how that will affect ETF shareholder value.

When is liquidity too much of a good thing? If you cannot resist the temptation to trade because it is so easy, then you have justified John Bogle’s famous claim that for some investors, buying “an ETF is like handing an arsonist a match.”

Using Individual Bonds to Provide Liquidity

Liquidity enables you to raise cash quickly at a reasonable price in order to purchase what you want and need. It enables businesses to purchase goods and pay salaries until its inventory of goods is sold. Yet keeping a great deal of cash so that your assets are always liquid is not a good idea because the cash is not earning any money. Investing the cash provides an opportunity for profit, either from an increase in the value of the assets or as cash flow when the assets pay interest or dividends.

In a normal market, if you attractively price what you are selling, someone else will be buying because they see an opportunity. If the market bottom is falling out, market makers may step back. They are in the market to make money, not to absorb losses so you don't. If you view yourself as a trader, then you may already be aware of this. If you are a buy-and-hold investor, then you need to gain clarity on how long and whether you can hold your position.

- Buy-and-hold bond investors, for example, may know that:
- They bought bonds to create an income stream, a paycheck.
- Their bonds will eventually be called or come due at face value.
- They do not need to worry about interest rate fluctuations because their income stream is not affected.
- Trading costs money and may trigger taxes as well.

One headline from Bloomberg read "Liquidity, liquidity, liquidity are the three most important words for bonds." We ask whether investors have provided for their own liquidity needs. Do they own individual high-quality bonds they can hold to maturity that create a stream of income? Do they have a line of credit or money in a money market account?

An individual investor can own bonds without having to sell them if he or she has planned for their own personal sustainability and financial independence.

This article originally appeared in the October 2015 issue of the* AAII Journal*.

→ **Hildy Richelson** is president of Scarsdale Investment Group, a registered investment adviser based in Blue Bell, Pennsylvania, that specializes in fixed-income investments. Hildy and Stan Richelson are co-authors of several books on bonds, including **"Bonds: The Unbeaten Path to Secure Investment Growth," Second Edition** (Bloomberg Press, 2011). **Stan Richelson** is a representative of Scarsdale Investment Group, a registered investment adviser based in Blue Bell, Pennsylvania, that specializes in fixed-income investments.